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First National City Bank Monthly Letter

Business and Economic Conditions

New York, July, 1958

General Business Conditions

THE economy at midyear is marking time, with the downturn arrested but no indication as yet of a vigorous recovery. A sufficient number of the basic economic indicators now show moderate gains over the low points reached in late winter or early spring to provide assurance that the expected "bottoming out" has in fact occurred. On a seasonally adjusted basis, small but encouraging increases were registered during May in industrial production, personal income, retail sales, housing starts, and total employment. Preliminary data indicate that these advanced levels were at least maintained in June.

The temptation to take a rosy view of imminent recovery is strong, but a more likely prospect, as described by Presidential assistant Gabriel Hauge, is that the economy "will mill around in the summer." The hope aroused by recent favorable developments is moderated by the prospect that seasonal declines will be accentuated in steel, automobiles, and other lines, that liquidation of inventories will continue, and that businessmen will cut plant and equipment expenditures further.

Prospects for Production

The Federal Reserve index of industrial production (seasonally adjusted, 1947 - 49 = 100), which had declined from a peak of 146 to 126 in April 1958, picked up a point in May to 127. It is encouraging that this rise came about from recovery in the two lines that had been the hardest hit in the recession — steel and automobiles. In June, steel mill operations have averaged about 20 per cent above May, and auto assemblies held steady. Weekly output in early June was steady or rising in the petroleum, paperboard, coal, and lumber industries.

An attitude of caution is counseled by the fact that neither steel nor automobiles expects uninterrupted recovery. The rapid rise in steel mill operations from 47 per cent of capacity in late April to 65 per cent in mid-June was attributable in part to hedging against the possibility of higher prices following the automatic wage boost on July 1. Customers whose steel inventories had been worked down to a low level felt they had little to lose by replenishing stocks, and steel mills themselves reportedly did some rebuilding of stocks of semifinished steel before July 1, when their employment costs increased approximately 20 cents an hour. Lower operations are being scheduled for the early summer.

The first automobile shutdowns are already occurring as the 1958 model year draws to an end. Automobile dealers are expected to enter the second half with stocks somewhat less than 700,000 cars, which at current sales rates are equal to roughly seven weeks' sales. With some new models scheduled for introduction in mid-September, this does not leave room for much additional production of '58 models. According to Ward's Automotive Reports, third quarter production schedules call for only 600,000 passen-

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ger cars (both new and old models) – a marked decline from the 1,000,000 cars turned out in the second quarter and less than half the 1,304,000 cars assembled in the third quarter of 1957.

Summer vacation shutdowns at many textile mills will be longer than usual this year, and other industries are expected to use the same means of working off finished goods stocks. Altogether, the combined influences of vacations, model changes, and loss of the temporary stimulus of hedging demand point to a greater than seasonal reduction in output during the summer.

It would not be unusual for industrial production to fall back again after a brief advance from recession lows. This has happened in a number of previous recessions. In 1954, the industrial production index hit bottom in March at 123, rose to 125 in May, but dropped back to 123 in July and August. The real recovery did not start until six months after the low point had first been reached.

At the same time, it would not be inconsistent for a broad measure like the gross national product to advance somewhat in the third quarter despite a renewed decline in industrial activity. The gross national product includes the homebuilding, trade, and service industries and government service – most of which are expected to be stronger in the second half – as well as the manufacturing and mining industries covered by the production index. Manufacturing is a key sector of the economy, but in the short run it can and does move contrary to the economy as a whole.

A Powerful Stabilizer

Throughout the business decline, the relatively steady flow of personal income has been a powerful stabilizing influence. Despite the sizable contraction in general economic activity, disposable personal income in the first quarter was down only $4 billion, or 1 per cent, from its peak annual rate and was probably off even less in the second quarter. Increased government transfer payments – unemployment insurance, social security, and veterans' benefits – have offset $5 billion of the $8 billion decline in the annual rate of labor income and have been largely responsible for the advance in personal income in March, April, and May. A further rise in personal income is likely when expanded unemployment insurance goes into effect in many States and the Federal Government increases salaries nearly $1½ billion a year for post office employees, civil service workers, and the armed forces.

The stability of income more than anything else appears to be responsible for the continued high rate of consumer spending. Expenditures on services have risen without a break, while retail sales of goods – like personal income – had recovered by May approximately half their moderate decline.

In turn, the steadiness of consumer demand is helping business weather the inventory adjustment phase of this recession, as it did in both previous postwar recessions. When inventories are being liquidated, as they are now at near-record rates, more goods are being consumed than produced. Eventually, as stocks diminish, production must rise to the level of consumption, or consumption must fall toward the level of production. The difference between these alternatives is the difference between recovery and a downward spiral.

Fortunately, consumption has held up, and production is already edging up to close the gap. This gap between consumption and production may not close quickly or evenly, but long strides have been made. The better consumption is maintained, the easier the job will be. Buyers have been coming back into the markets – cautiously, to be sure, but at least they are buying. Manufacturers received a moderately greater flow of new orders in March and April than in February, and purchasing agents report improved order positions in May as well.

Adjustments in Prices

The failure of price indexes to decline in a period of inventory liquidation has caused much comment. The comprehensive Bureau of Labor Statistics index of industrial prices (all commodities other than farm products and foods) has edged down only 0.7 per cent from its January peak, while consumer prices were still rising in May. However, competitive markets have brought about a greater degree of price adjustment than the indexes are able to measure. When the manufacturer's desire to move goods conflicts with his desire to maintain his basic price structure, prices actually charged are apt to be shaded in a variety of ways which do not affect listed prices. For instance, the base price of steel in June had remained unchanged for nearly a year, yet the net cost to the buyer was in many cases substantially reduced through the elimination of premium prices, omission of extra charges, or absorption of freight.

Price competition has made inroads on corporate profits. Because of this, it compels business to seek higher degrees of efficiency as well as resist further labor cost increases. A recession is the time for trimming unnecessary expenses, pushing for more efficient use of men, money,

and machines, and intensifying selling efforts and new product development. It is a time when superior efforts are rewarded and when the inefficient are weeded out.

Further Contraction in Capital Spending

The biggest adjustment still facing the economy is that of growing up to its expanded industrial capacity. In many lines this involves marking time on new expansion programs until demand catches up. Meanwhile the bulk of capital spending must come from replacement needs and opportunities to cut costs, promote efficiency, or bring new products to market.

In the third quarter, businessmen are scheduling plant and equipment expenditures at a seasonally adjusted annual rate of $30.3 billion, down 3 per cent from the preliminary second quarter rate and 20 per cent below the record third quarter of 1957. Data on capital appropriations, spending plans, and industrial construction contracts indicate the decline in expenditures for capital goods will continue into 1959.

This prolonged reaction to the capital spending boom of 1955-57 will be a drag on recovery. Yet one would hardly expect businessmen to make upward revisions in their capital spending programs until the strength of recovery is such as to make current capital planning inadequate. Even then, it takes time for such revisions to be reflected in increased plant and equipment expenditures.

Enough strength is appearing in defense, home building, and public works to offset the continued decline in capital expenditures. Once the summer lull is past, prospects are good that business activity in general will be able to move up moderately. As yet, however, there is no evidence of a force which would push the economy upward in a vigorous recovery. In such circumstances it is healthier to plan conservatively. It is easier and better to have to revise estimates upward than to be unduly optimistic, overshoot the mark, and make necessary further adjustment.

The Changing Pattern of Inventories

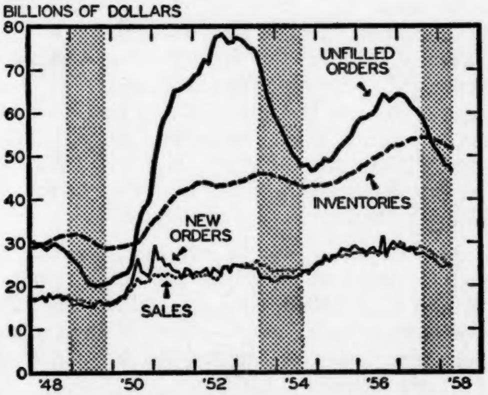
Inventory adjustment has been the most important characteristic of the first phase of the business recession. Fully two thirds of the $18 billion decline in the annual rate of output of goods and services has been accounted for by changing demand for inventories. Businessmen, who had been accumulating stocks at a $3 billion annual rate in the third quarter of 1957, were working them off at a $9 billion rate in the first quarter of 1958. The course of business activity in the months ahead will be closely linked to inventory behavior.

In such a situation, a closer look at inventories seems well worth while.

To begin with, it is important to understand that an inventory change is not always brought about because someone decides stocks are "too high" or "too low." Businessmen can and often do deliberately change their inventory policy—aiming at higher or lower inventory levels. However, many inventory changes are involuntary rather than voluntary. In short, inventory demand is dependent upon what is happening to output and sales generally. They are symptoms of changes taking place in new orders, production, or shipments. Prices, credit availability, and delivery schedules also affect the level of inventories.

Stocks are high or low relatively rather than absolutely. A certain level of inventories might have been inadequate last year in an atmosphere of scarcity, delayed deliveries, heavy sales, and rising prices, but that same level might be excessive today with ready availability of materials, declining sales, and stable prices.

The interaction of three important influences upon inventories is shown in the first chart, which traces the course of manufacturers' shipments, new and unfilled orders, and inventories since 1948. These figures are compiled by the U.S. Department of Commerce. The shaded portions represent periods of decline in general business activity as determined by the National Bureau of Economic Research.

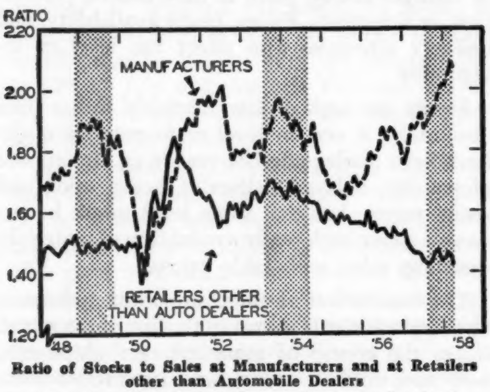


Manufacturers' Sales, Inventories, and Orders
Seasonally adjusted (except unfilled orders); last figures shown are for April

This chart demonstrates the tendency of factory inventory adjustment to lag behind changes in orders and shipments (or sales). The sequence in a decline is a natural one: new orders weaken

and fall behind shipments several months in advance of the downturn in business generally; backlogs of unfilled orders thus decline; as order backlogs are worked off, shipments turn downward and production is curtailed. Inventories accumulate at first, but a couple of months after adjustments have been made in production, stocks too start edging downward. A similar pattern of leads and lags occurs in a typical upturn.

An even more pronounced lag occurs in the ratios of inventories to shipments, as shown in the second chart. This ratio, often referred to as the stock-sales ratio, represents the number of months that end-of-month stocks would last at the rate of shipments in the preceding month.



Ratio of Stocks to Sales at Manufacturers and at Retailers other than Automobile Dealers
Seasonally adjusted; last figures shown are for April

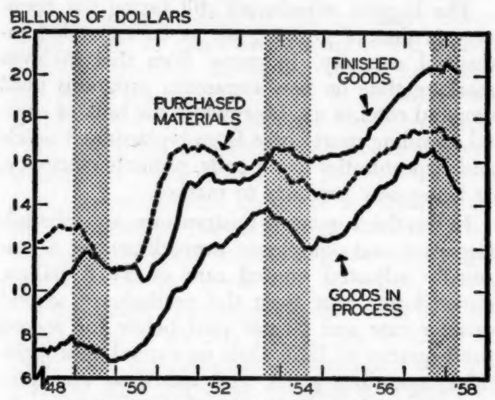
The stock-sales ratio is frequently used as a measure of the adequacy or excessiveness of inventories. However, because stocks tend to move more sluggishly than sales or shipments, such ratios often begin to appear excessive only after sales have dropped. In each of the three postwar business declines, the factory stock-sales ratio continued to rise for 5 months or more after business in general had turned down and even for several months after inventories themselves had started to contract. In both 1949 and 1954, the factory stock-sales ratio was higher at the trough of the general cycle than at the peak.

At the cyclical peak in July 1957, the ratio of factory stocks to sales was 1.87. Eight months later in March 1958, this ratio had risen to 2.09. Weakness of sales, not the level of stocks, had been responsible for boosting the ratio. In April the ratio flattened at 2.07.

Retailers other than automobile dealers have succeeded in keeping their inventories closely in line with sales; the ratio was 1.43 in July 1957 and 1.42 in April 1958. In the automobile industry, however, the dealers' stock-sales ratio has risen from 1.34 in July 1957 to 1.62 in April 1958.

Inventories by Stage of Fabrication

The lag in factory stocks during an adjustment period can be better understood after examining the behavior of inventories at different stages of the manufacturing process, as shown below.



Manufacturers' Inventories by Stage of Fabrication
Seasonally adjusted; last figures shown are for April

By far the largest share of inventory liquidation has been in stocks of goods in process, reflecting the sharp cutback in production. Goods in process rise and fall almost automatically with changes in manufacturing activity, although over the long run they also reflect price movements and shifts in the share of production which is devoted to long lead-time durable goods. Since July 1957, the volume of goods in process has dipped 11 per cent (entirely in durable goods).

Stocks of purchased materials, which include semifinished goods as well as raw materials, are down 4 per cent from last July's business peak. Even before this, however, cautious and foresighted management policies on ordering and holding inventories helped to keep down purchased materials stocks. Changes in suppliers' delivery schedules also affect the rate at which such stocks accumulate, and changes in production scheduling govern the rate at which they are drawn down. In practice, purchased materials stocks have not conformed as closely to the swings in general business as goods in process have. For example, after production passes its peak, stocks of materials may pile up involuntarily as their consumption slows down, while, in the initial stages of an upswing in production, stocks of materials are consumed more rapidly than they can be replenished.

The lag in inventory changes behind the general business cycle is primarily the result of the movement of finished goods stocks. In the three postwar declines, inventories of finished goods reached their peak 3 to 8 months after the peak

in general business. Ordinarily, only after sales begin to revive are manufacturers able to make much headway in moving finished goods stocks.

Finished goods include all products in the form in which they are sold by the manufacturer. Thus, sheet steel and print cloth are finished goods at the mills where they are made, but they are purchased materials to the firms which buy them for further processing. When purchasing agents adopt hand-to-mouth buying policies, they throw the burden of carrying stocks back on the preceding stage of the manufacturing and distribution process. When sales improve, the additional demand all along the line is met initially from finished goods stocks. Thus, the tendency is for finished goods inventories to move in the opposite direction from sales during most of the business cycle – rising when sales start falling and falling when sales start rising.

Inventory Prospects in 1958

It is still an open question how soon inventory liquidation will come to a halt. The widespread anticipation of moderate recovery later in the year does not, on the evidence presented here, preclude further working off of stocks. Indeed, such liquidation would be normal, for total business inventories have dipped only 4 per cent from their peak, compared with a drop of 8 per cent in business sales in the same period. In the 1948-49 recession, the over-all reduction in inventories from peak to trough amounted to 6.6 per cent, and in 1953-54 the dip was 5.5 per cent.

From the standpoint of industrial activity, however, the important point is how fast inventories are being liquidated. The substantial progress which already has been made in limiting factory stocks of purchased materials and goods in process argues for a tapering off, if not a bottoming out, of the decline in such inventories. Manufacturers' finished goods stocks, however, are likely to decline further as sales start to improve. Liquidation of new car dealers' stocks will probably dominate retail inventory trends in the months ahead. Altogether, prospects are for continued inventory liquidation but at a slower rate, with increased production making up for goods now being sold out of stock.

Treasury Debt Lengthening Efforts

The U.S. Treasury's June financing operations furthered its courageous efforts to lengthen public debt maturities. On its refunding June 15, when $9.5 billion notes and bonds came due, the Treasury offered 11-month 1¼ per cent certificates to holders who demanded short-term securities but held out the lure of a 2⅝ per cent rate to those who would accept in exchange 6-year 8-month bonds due February 15, 1965. The operation was highly successful. No less than $7.4 billion of the maturing securities were converted into bonds, another $1.8 billion into certificates, and a residual of only $356 million was left requiring redemption in cash.

Underscoring Treasury Secretary Robert B. Anderson's determination to gain and hold a participation in all areas of the market was a cash offering of $1 billion 27-year 3¼ per cent bonds due May 15, 1985. This was the Treasury's seventh bond offering since last September, and the third long-term issue.

In view of apprehension that a long bond might cut down funds available for mortgage and corporate and municipal bond investments, the Treasury limited its offering to $1 billion. The new 3¼s were offered to yield 3.22 per cent, only a little above yields on comparable outstanding Treasury maturities, though this required the unusual step of asking the buyer to pay a premium price of 100½.

The long bonds were initially quoted at 101⅛, moved up to 101½ but later eased to par. The new 2⅝ per cent bonds slipped to 99⅝ as the market tended to react to the more favorable tenor of business news which seemed, at least for the time, to exclude further Federal Reserve measures to ease credit. The bond market was particularly sensitive because dealer inventories were heavy and speculators had built up positions in bonds – most notably in the new 2⅝s – in expectation of capital gains out of further moves to increase the credit supply.

Though the Federal Reserve authorities have continued to conduct their open market operations with the effect of sustaining member bank free reserves in a range around $500 million – as has been true since March – the movement of yields on new issues of 91-day Treasury bills during June seemed to convey some hint that the extremities of easy money might have passed. The 91-day bills dated May 29 were sold at an average rate of only 0.64 per cent, comparable to the 0.62 per cent touched at the low point of the 1954 cycle. From that point bill yields moved up to 1.01 per cent on the issue dated June 26.

Return to the Bond Market

The Treasury's offering of 12-year 4 per cent bonds last September, after a two year absence from the bond market, followed close upon the heels of strong criticism of Treasury debt management in Congress. In the course of last summer's Senate Finance Committee hearings on "The Financial Condition of the United States,"

retiring Secretary of the Treasury George M. Humphrey was forced to admit that he had inherited "a mess" and was passing on "a mess" to Secretary Anderson, his successor. Ironically, some Senators who had criticized the Treasury in 1953 for paying 3¼ per cent to sell 30-year bonds complained that the Administration had not accomplished its announced goal of stretching out public debt maturities.

The tight money market in 1957 also provided a painful lesson for the Treasury on the costs of failing to push out debt maturities at more favorable times. The Treasury found it impossible to borrow long-term money at the top of the boom when a congested market simply had no appetite for Treasury bonds. Even shorter term financing was difficult. Despite rates of 3½ and 3⅝ per cent — highest since 1933 — an exchange offering in May of $4.2 billion certificates and notes was left 28 per cent unsubscribed. The climax came in August when the Treasury paid 4.17 per cent on special Treasury bills.

These embarrassments led the Treasury to pursue its debt lengthening policy in a more energetic way. A favorable opportunity was presented by the business recession, which brought reduction in the demands for money from business and consumers, and by Federal Reserve actions to increase the credit supply.

Opposition to Long Bonds

The decision to offer the new 3¼s was made in the face of considerable opposition. The most impressive argument was that they would interfere with the Federal Reserve's policy of credit ease by "locking up" long-term funds needed by other borrowers — industry, State and local governments, and home buyers. The further point was made that additions to the supply of long-term issues will prevent interest costs from declining as much as needed to stimulate a revival of long-term borrowing and encourage economic recovery. The idea is that the Treasury should concentrate on selling short-term issues to increase the liquidity of the economy.

While the Treasury noted these objections, it also took into account the fact that current Federal Reserve policy and Treasury deficits are already adding rapidly to the liquidity of the economy, as measured by the total supply of bank deposits and short-term cash equivalents like U.S. Treasury bills. Moreover, funds do not get "locked up" in bonds so long as the market is under the influence of business recession and an easy credit policy. In these circumstances bonds naturally have a buoyant tone which means they can be sold at a profit. Thus the holder has liquidity plus a profit, which is better than money in the bank. He can sell out whenever a more attractive opportunity to lend or invest appears. To be sure, business recovery and a restrictive credit policy bring lower bond prices. But it is at this stage that some loan funds need to be "locked up" and the virtues of debt lengthening assert themselves.

It is no doubt true that long-term interest rates — already down 1 per cent or more from their 1957 peaks — would be somewhat lower if the Treasury had not issued the 3½s of 1990 and the new 3¼s of 1985. But there is no evidence that rate levels are deterring borrowers from taking advantage of the ready availability of credit. Far from needing more stimulus, new bond issues by State and local governments totaled a record $3.8 billion in the first five months of 1958, 25 per cent above January-May 1957. Moreover, despite the decline in business activity, new corporate bond flotations during the same period are estimated at about $4½ billion, 10 per cent ahead of 1957's record pace. Applications for Federal Housing Administration mortgage insurance in May were the highest in history.

Opposition also came from adherents of the penny-wise, pound-foolish proposition that the Treasury should always borrow in the cheapest area of the market. This would dictate bond issues only on the rare occasions when short-term rates exceed long-term rates. Long-term rates paid under this procedure — though lower than short-term rates available at the same time — would be far above the cost of bond issues in more normal periods. The Treasury would have had to pay more for interest on the public debt in 1956-57 if it had not placed so many bonds at 2½ per cent in 1954.

When it comes down to long-term interest rate levels we need to bear in mind the widespread view that we are in an age of inflation which subjects the bondholder to an extra exaction over and above regular income taxation. When long-term rates decline too far investors shift attention to ownership of real property and equities. Sustained investment interest in bonds and mortgages is necessary for the economy to finance its long-term capital needs. A 3¼ per cent rate for long-term Treasury financing is little enough when one remembers that the income is taxable and the value of the dollar has fallen an average of 2.2 per cent a year during the past decade. Other countries where inflation has gone faster have to pay higher interest rates. France finds it possible to sell bonds at 3½ per cent but this is tax exempt

and the bonds are made, in practical effect, redeemable in gold coin. The United Kingdom as recently as February offered bonds paying 5½ per cent at a discount price of 98½.

Postwar Debt Management

Out of the total U.S. debt of $277 billion, no less than $120 billion of public issues (including $52 billion of Savings bonds) are due or payable within one year and all but $58 billion within five years. The accumulation results from failure to act energetically to lengthen maturities earlier in the postwar period. But even at the close of June 1946 less than one fifth of the public debt was funded in bonds maturing beyond twenty years. In contrast, on June 30, 1919, after the close of World War I, half the debt was not due until after twenty years.

Since June 30, 1946 the Treasury has issued, apart from Treasury bill offerings, no less than $488 billion of marketable securities. As the following table shows, only $52.8 billion were bonds and of these only $7.2 billion had a maturity beyond twenty years.

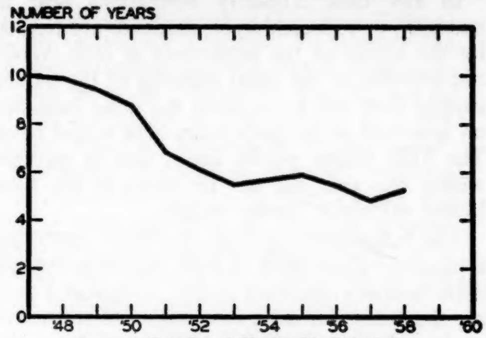
Postwar Treasury Bond Issues
(Dollar figures in millions)
Term to Maturity

	5-10 Years	10-20 Years	Over 20 Years	Total
1946-51	$ —	$ —	$ —	$ —
1952	5,172	—	—	5,172
1953	4,607	—	1,606	6,213
1954	21,738	—	—	21,738
1955	—	—	2,745	2,745
1956	—	—	—	—
1957	—	1,311	—	1,311
1958 Jan.-June	12,722	—	2,860	15,582
	$44,239	$1,311	$7,211	$52,761

There were no bond issues at all from 1946 to 1951, though beginning in 1949 Treasury Secretary John W. Snyder made some probing attempts toward debt lengthening by issuing four and five year notes. In 1952 Mr. Snyder moved further, putting the Treasury back into the bond market by issuing six and seven year bonds. On the other hand, to soften the blow of the unpegging of the bond market in March 1951, maturities on $15 billion of marketable bonds were shortened, at the option of the holder, from 19 or 21 years to 5 years.

As the chart shows, the average maturity of the interest-bearing, marketable public debt, computed to final maturity in all cases, fell from 9 years 11 months on June 30, 1947 to 5 years 6 months at the close of June 1953.

It was not until 1953, eight years after the close of World War II, that the Eisenhower Administration reopened a market for long-term Treasury obligations by selling $1.6 billion 30-year 3¼ per cent bonds. Reflecting the vehemence of attacks on the Treasury for paying such a "high" rate as 3¼ per cent, and apprehensions



Average Maturity of Marketable U.S. Debt
June 30 dates, 1947-58

that long-term bonds would interfere with recovery from the 1954 recession, the Treasury until February 1955 held bond offerings within a 10-year limit.

Almost $22 billion bonds were issued in the 5-10 year range during 1954, mainly in exchange for maturing issues. The average maturity of the marketable debt rose to 5 years 11 months in June 1955. A suspension of bond issues after July 1955 brought a renewed down-hill slide to an average maturity of 4 years and 10 months in June 1957, a new low.

The $16.9 billion bonds sold since last September have raised the average maturity of the marketable debt to 5 years and 3 months. This is 5 months longer than it was a year ago, but still 3 months short of the June 1953 figure. It may seem a little surprising that more progress has not been made. But it must be remembered that, had no debt lengthening efforts been made, the mere passage of time alone would have shortened the debt by nearly twelve months. As former Under Secretary W. Randolph Burgess has said, "with this huge debt, getting shorter day by day, you have to run fast to keep even."

Debt Management and Credit Policy

There is hardly anything more important to credit policy than debt lengthening. A swollen floating debt almost always exerts an inflationary influence, if only because it makes the monetary authorities feel impelled to put out a little more money every now and then to facilitate Treasury refinancing. Way back in May 1921, Governor Montagu Norman of the Bank of England, writing to Benjamin Strong, President of the Federal Reserve Bank of New York, said that, "so long as a Government has directly or indirectly a large floating debt, I wonder if any system can leave the Central Bank of that country really free to manage affairs from a purely financial standpoint."

In any case, Treasury obligations near to maturity, or redeemable on demand, are treated by the holder as the equivalent of cash. While not included in the usual statistics of the money supply, they can have much the same influence on spending as so much extra cash would have. The $120 billion public issues due or payable within one year are not far short of the $135 billion calculated money supply.

The inflationary upsurge of 1955-57 provided a practical illustration of how excessive floating debt hampers monetary policy. Frequent Treasury financings forced a moderation of restrictive credit policies repeatedly. At the same time, the excessive volume of short-term Treasury securities outstanding cushioned the impact of credit restraint. Lenders were able to raise funds for loans, despite a restrictive Federal Reserve credit policy, by letting short-term Treasuries mature or by selling them without serious loss.

The Deficit Problem

What makes it quite imperative for the Treasury to tap the long-term market is the federal deficit, now swelling beyond $10 billion a year. Whatever fraction of this amount the Treasury is able to cover with long-term borrowing, the fact remains that shorter-term borrowings will also rise, and almost certainly to a much larger extent. The short-term debt will rise to plague the authorities when the problem recurs of checking price inflation.

The use of stimulants in recession – easy money, increased government expenditures and deficits, buildup of short-dated U.S. debt – demands discretion. The problem is to encourage recovery without laying the groundwork for unbridled inflation which gets going when the budget is hopelessly out of control and the economy supersaturated with money and short-term claims upon the Government for more money.

France and the Common Market

The most challenging economic experiment of the postwar period is the creation of a Common Market between France, Germany, Italy, and the already integrated Benelux Union of Belgium, Netherlands and Luxembourg. The Common Market – formalized as the European Economic Community (EEC) under the Treaty of Rome in March 1957 – came into legal existence on January 1, 1958. The plan is gradually to lower, and finally to eliminate, tariff and import restrictions among the Six. If all goes well there will exist in Western Europe, 12 to 15 years hence, a unified trading area rivaling that which we have in the 48 United States.

There are skeptics who say the scheme cannot work. Unlike the United States, which has a common language and common nationality, Europe has many languages, prides of nationality, and a background of recurrent conflict including two major wars during the present century. As an immediate practical illustration of problems involved, the recent French balance of payments crisis pointed up the fiscal and monetary discipline that will be required of all members to make the Common Market work. In the words of former French Premier and Minister of Finance Edgar Faure, the challenge presented by the Common Market "does not so much create new problems as bring old ones into light."

The new French Government is facing up to its problems realistically. It is hewing to the line of the financial reforms instituted last winter under Premier Felix Gaillard, holding government expenditures within a fixed ceiling and getting away from the bad old habit of using the Bank of France to cover deficits. Simultaneously, the Bank of France has been enforcing a credit squeeze on the banks and is successfully building a higher respect for the franc at home and abroad. Fiscal and monetary discipline seems a small price to pay to avoid the ravages of inflation and foreign exchange crises, to gain widened avenues of economic freedom, and to raise horizons for European prosperity.

Background of the EEC

A generation ago it would have seemed incredible that continental European countries would give up protection for domestic industries and embark on a far-reaching program of trade liberalization and economic unification. But since World War II there has been an awakening to the fact that nationalistic restrictions waste productive resources and indeed are earmarks of economic weakness. One of the secrets of American prosperity is the breadth of our market, which provides extensive opportunities for realizing the economies of large-scale production and distribution and for placing industries where natural advantages are greatest. The EEC is an attempt to create the same kind of market by the removal of customs barriers and the coordination of economic policies.

The Six have agreed to sacrifice some measure of independence to gain these benefits. This perhaps could never have been accomplished in the absence of the threat of the Communist Empire to the East. The unprovoked attack on Korea in 1950 accelerated European integration as did the closing of the Suez Canal in 1956. The unexampled resurgence of Western Germany

under free-market policies provided a working model for progress through individual initiative.

European cooperation, embracing larger or smaller groups of countries, has moved steadily ahead for ten years beginning with the Marshall Plan of 1947 which led in 1948 to the Organization for European Economic Cooperation (OEEC) embracing 17 countries. The same seventeen in 1948 set up a European Payments Union (EPU) through which they have cleared transactions, cooperated to liberalize trade, and helped one another over periods of temporary financial strain. The Six that are now forming the Common Market have operated their European Coal and Steel Community (ECSC) for seven years. The three Benelux nations, starting in 1948, already have a Customs Union similar to that planned for the EEC.

The mutual benefits from these ventures in cooperation have encouraged them to go further. Indeed, the idea of regional integration is attracting attention in other areas of the world.

The Rome Treaty

The Treaty creating the European Economic Community is a formidable document. It aims not only to eliminate trade barriers among the Six, but to align their economic, financial, agricultural, and social policies as well. Article 2 states:

> The Community's mission shall be, by establishing a common market and gradually removing differences between the economic policies of Member States, to promote throughout the Community the harmonious development of economic activities, continuous and balanced expansion, increased stability, a more rapid improvement in the standard of living and closer relations between its Member States.

While many of its provisions are quite specific, the Treaty is more a statement of broad principles and guidelines than of detailed programs and mechanisms. The resolution of many aspects is left for the future, and "escape" clauses are provided for meeting unexpected difficulties.

The institutions governing EEC are largely modeled after those of the Coal and Steel Community. A Council of Ministers, with one member from each of the six governments, must approve most major EEC decisions. Council action, however, is often limited to accepting or rejecting proposals drawn up by the nine-man commission charged with day-to-day administration of EEC affairs. Commissioners are forbidden to receive instructions from their governments and are charged with acting in the best interest of the Community.

A European Investment Bank capitalized at the equivalent of $1 billion will provide funds, when not available privately, for financing development and modernization projects deemed to be in the Community's interest. To promote the social and economic development of their non-European territories, members have agreed to place the equivalent of $580 million in a Development Fund for investment in both "social" and production facilities in overseas countries and territories. The European Social Fund will share the costs incurred by member governments in retraining and relocating workers who lose their jobs through the elimination of less efficient firms and production methods.

Treaty Timetables

To relieve the impact, trade restrictions are to be removed gradually over a 12 to 15 year transition period.

As a first step, duties within the Community must be reduced by 10 per cent as of January 1, 1959.

The liberalization and ultimate removal of import quota restrictions among participants is also to be accomplished in stages.

Tariffs on imports from outside the Community will gradually be made uniform, generally at the arithmetic average of tariffs in force in the six countries on January 1, 1957.

As for quotas on imports from outside the Community, the Treaty provides only that the member states will work toward their maximum liberalization.

Appendices list duties subject to special rules. While a few of these are left to future negotiation, most are specified. Some tariffs have been set above the average, often at the request of the French, in order to protect certain producers at home and in overseas territories. Others, primarily on raw materials and semifinished products, have been set lower. Petroleum, cotton and oilseeds are made duty-free.

Henceforth the Six will negotiate as a single unit in all economic discussions with other countries. They have pledged to carry on such negotiations in the spirit of the trade liberalization policies of the General Agreement on Tariffs and Trade (GATT), of which they all are members.

Free Trade Area

The tariffs around the Six, and preferential treatment for producers within the area, raise serious policy questions for countries outside the area. American businessmen have been pressing their bankers for advice and, where they do not already possess plants within the area, have been considering buying interests in going concerns, putting up new plants, or negotiating licensing arrangements. Their dynamic approach to mass

marketing opportunities adds new competitive vigor to the European scene. While there are risks, there are also opportunities.

The Common Market should be helpful to many raw material producing countries, since applicable tariffs are generally low and the scheme promises to stimulate growth of industry and raw material needs in Europe. Manufacturers shipping from plants outside the market, however, will suffer competitive disadvantage. This is disturbing to American exporters, but more serious for other European countries which depend heavily on exports to Common Market nations. For political reasons these peripheral countries have been unable or unwilling to associate themselves with the closely-knit EEC venture. But they would like to join an economic union in which they would retain more freedom of action, particularly the right to levy their own tariffs on imports from outsiders. The United Kingdom, seconded by Scandinavian countries, has urged the establishment of a so-called Free Trade Area in association with the EEC, enlarging the area of unrestricted European trade to all 17 members of the OEEC. The project has support within the Common Market, particularly from Germany and the Netherlands.

Such a further step would greatly increase the area of trade liberalization and develop even higher levels of specialization and trade among European countries. As the table shows, the FTA would make a trade unit substantially bigger, population-wise, than the U.S.A. The table also brings out the lead the U.S.A. presently holds industrially and the way the EEC and FTA countries have been gaining ground since 1950.

Comparison of European Economic Community (EEC) and Free Trade Area (FTA) with United States

	1957			% Increase 1957 over 1950		
	USA	EEC	FTA	USA	EEC	FTA
Population (mil.)	171	164	288	13	6	6
Gross product (bil. $)	434	150e	260e	52	100e	84e
Per capita gross prod. ($)	2,537	915e	903e	35	90e	75e
Total exports (bil. $)	19	22	40	95	141	103
Total imports (bil. $)	13	25	46	47	121	91
Exports to U.S.* (bil. $)	—	1.5	2.9	—	170	133
Imports from U.S.* (bil. $)	—	3.2	5.3	—	99	89
Production						
Steel (mil. tons)	118	66	97	16	88	72
Coal (mil. tons)	515	278	530	–8	14	9
Cement (mil. tons)	56	55	80	32	81	69
Electricity (mil. kwh)	716	220	402	84	84	75
Passenger cars (mil.)	6.1	2.0	2.9	–8	249	158
Comml. vehicles (mil.)	1.1	.5	.8	–19	124	60
Consumption						
Aluminum † (mil. tons)	1,778	461	896	98	166	103
Copper † (mil. tons)	1,521	888	1,555	7	72	54
Zinc † (mil. tons)	988	605	937	2	89	28
Petroleum (mil. tons)	454e	60	114	33e	152	115

* U.S. Department of Commerce concept.
† 1956. e — Estimated.

The position taken by the U.S. Government toward the Common Market and the proposed Free Trade area has been one of encouragement since it has consistently supported a greater political and economic cohesion in Western Europe within the Atlantic community as well as a trend toward freer, nondiscriminatory, multilateral trade and convertibility of currencies. At the same time it is concerned that the lowering of barriers within Europe should not be accompanied by raising tariffs or tightening trade restrictions against other countries of the free world, including the United States.

Discussions had been pushed in the hope of gaining agreement in time to get a Free Trade Area in operation next year, simultaneously with the initial tariff cuts within the Common Market. Formal talks were suspended with the French cabinet crisis in mid-April but hopes persist that agreement may be reached on uniform tariff reductions throughout the proposed area effective next year.

The Role of France

The French crisis left the fate of European trade liberalization hanging in the balance. The new de Gaulle Government gave assurances that France would honor her international obligations while recognizing that more than good will is necessary for France to fulfill her commitments in EEC. Antoine Pinay, the new Minister of Finance, told newsmen on June 3 that France would not be able to fulfill her obligations in the EEC completely unless a tremendous effort was made between now and the end of the year. That effort is being made.

France is critically important. It is the largest Western European country in area and has the best diversified economy. The trouble is that France has been unable to find political continuity and financial stability since World War II. It has come to be recognized that fundamental constitutional reform is necessary to create a government strong enough to settle the Algerian problem and sustain monetary and fiscal discipline. The task of accomplishing these reforms has been given, along with a six months' grant of special powers, to the new government of General Charles de Gaulle.

The French economic position is a paradox. Production indexes show that France has participated fully in the rapid rise of West European output in the post-Korean period. In fact, since 1953 this rise has been about as great as that of Germany. But while Germany has had a stable currency and almost embarrassingly large trade surpluses, France has continued to suffer from inflation and has experienced alarming losses of financial reserves and increases in her foreign debt. The burden to France of military costs is an extenuating circumstance; on the other hand France has been the beneficiary of aids and

credits from foreign governments and international institutions. These, along with export subsidies and import restrictions, have prevented collapse but without solving the fundamental difficulties created by government over-spending.

Mounting government expenditures and deficits put too many francs in circulation and too much upward pressure on French wages and prices. Distrustful of the franc and government bonds, people tended to put their savings in gold and other real values. Unwilling to limit expenditures to what could be raised in taxes or borrowed in the market, the government relied too often on the Bank of France to create money. Rising prices impeded French exports and foreign exchange earnings while adding to the desires of the people for foreign goods that had to be paid for in foreign currencies.

M. Pinay told the French people in a broadcast June 17 that the country is up against "hard realities" and that "the disorder of our finances is at the root of our difficulties." To rebuild reserves and reduce money supply the Government on June 13 offered 3½ per cent bonds pegged to gold. Latest reports indicate the loan has met excellent response. During the first week it brought not only the equivalent of $50 million in cash but also some 10 metric tons of gold (about $11 million) into the Bank of France.

To encourage people to buy the bonds, the Government is allowing capital that had fled the country to be repatriated without penalty. A full restoration of the faith of people in the franc could rebuild the French currency reserve at a spectacular rate. It has been done before – 30 years ago. With proper government policies it can be done again.

A Lesson

It is perhaps as well that the long simmering French crisis came to a head before the Common Market was fully launched. There are many unresolved questions on which the EEC could founder. However, most of these – such as the problems of eliminating or modifying cartel agreements, differences in national tax structures and social welfare programs – should be amenable to goodwilled compromise. The French crisis provided a vivid example for all that the advantages of a unified market can be obtained only by exercising national economic and budgetary self-discipline. The frequent or prolonged reimposition of restrictions on trade and invisible transactions, as the Rome Treaty permits when a member faces balance of payments difficulties, would effectively remove the restricting country from the Common Market and sacrifice its advantages for all concerned.

In the Treaty of Rome the monetary problems of the European Economic Community were treated only in general principles. But the subject has been more fully explored in a statement prepared for the International Chamber of Commerce by an expert commission under the chairmanship of Maurice Frere, recently retired Governor of the National Bank of Belgium. Ideally, the EEC should have a single currency and every member should give up its sovereign right to issue money. But this is not today politically possible. Meanwhile, as the ICC's monetary commission points out, the need is for harmonization and coordination of monetary policies with mutual assistance in appropriate circumstances.

The success of the Common Market, the commission states, "depends basically on the equilibrium in the balance of payments of member states":

> If the Common Market is to be as far as possible an open Community, it must be founded on strong, stable and free currencies, capable of being integrated without difficulty into a broader system of international payments embracing all the leading currencies.

In order to develop "a common monetary discipline" the commission suggests:

1. That the conditions under which central banks grant credit to the private sector be coordinated and harmonized, at first by informal agreement and later by statutory provisions, perhaps under the proposed European Fund which is planned to succeed the EPU.

2. That the six governments agree to give up using the resources of their central banks to "solve their budgetary problems."

Just as our component States, in forming the Union, had to give up their rights to "coin money" and "emit bills of credit," the European nations, to enjoy comparable freedom of trade, must give up their "sovereign rights to inflate." The rewards are worthy of their cost, for they include not only a solid basis for trade and industrial progress but also a solid basis for confidence in the value of money.

Paul Henri Spaak, former Prime Minister of Belgium and now Director-General of NATO, has wisely said:

> No one can imagine all the difficulties involved in creating a new Europe. But without it, in 30 years' time, our Continent would become one of the free world's backward areas.

A booklet which discusses the Common Market in somewhat greater detail will be available later this month to interested readers. Requests should be addressed to our Public Relations Department, 55 Wall Street, New York 15, N. Y.